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California Court of Appeal Holds That Court Must Apply Equitable Standards To Expungement Application

On August 23, 2012, the California Court of Appeal, First Appellate District, held in *Lickiss v. Financial Industry Regulatory Authority*,[1] that the trial court erred in failing to apply basic equitable principles to a broker's claim for expungement relief. This decision, which expressly rejected FINRA's arguments that expungements could only be granted under the narrow grounds of Rule 2080, sets the stage for a potential flood of state court applications by brokers looking to expunge matters from their CRD records.

Background

Edwin Lickiss filed a petition in California Superior Court seeking to expunge 17 customer complaints and one regulatory disclosure related to filings made between 1991 and 1996. The petition invoked both the Court's jurisdiction under FINRA Rule 2080(a), which states that an associated person seeking to expunge information from the CRD system must obtain an order "from a court of competent jurisdiction," and the court's "equitable and inherent" power to effect expungements.

Among the matters the broker sought to expunge were thirteen disclosures all related to sales of stock in Commonwealth Equity Trust ("CET") between 1987 and 1991. CET went bankrupt in 1993, and several of the broker's clients (twelve of whom were represented by the same non-attorney "investor recovery" advocate, Richard Sacks), filed arbitration claims against the broker alleging that the investments were unsuitable and that the broker failed to disclose the risks associated with the securities.

In his petition, the broker argued that expungement should be granted because "(1) the material requested to be expunged occurred anciently, i.e., 20 or more years ago, (2) Petitioner's regulatory record has long since been and remained clean, and (3) the material sought to be expunged was overwhelming[ly] caused by the failure of a single investment security which Petitioner brokered for nothing more than ordinary commissions and over which Petitioner had no control or influence." FINRA demurred to the petition, arguing that the standards set forth in Rule 2080(b)(1) controlled the court's determination and that the broker had not presented any evidence or claims that he met the 2080(b)(1) standards. Rule 2080(b)(1), provides that FINRA may waive the obligation to name FINRA in a court proceeding to confirm an arbitration award containing expungement relief if the relief is based on "affirmative judicial or arbitral findings that: (A) the claim, allegation or information is factually impossible or clearly erroneous; (B) the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation or conversion of funds; or (C) the claim, allegation, or information is false."

The trial court, initially reluctant to dismiss the claim, eventually adopted the standard set out in Rule 2080 and found that the broker's petition failed to state facts sufficient to constitute a cause of action because he "failed to plead any basis which would entitle him to his requested relief of expungement under FINRA Rule 2080."

On appeal, the California Court of Appeal held that because the broker had specifically invoked the trial court's equitable jurisdiction, it was reversible error to sustain the demurrer for failure to plead any of the 2080(b)(1) "standards" for relief. Recognizing basic equitable principles, including the fact that "equity aims to do right and accomplish justice," the Court wrote that "courts cannot properly exercise equitable powers without considering the equities on both sides of a dispute." Recognizing

1 2012 Cal. App. LEXIS 915 (August 23, 2012)

the "inherent" power of expungement as applied in numerous states, the Court found that the trial court erred when it limited its consideration of the petition to only the Rule 2080 factors as argued by FINRA. In fact, the Court wrote that:

> If, as FINRA suggests, the Court believed that equity permitted it to rely exclusively on rule 2080(b)(1) to resolve the demurrer, the court erred. The choice of a very narrow, rigid legal rule to assess the legal sufficiency of [the petition] – a choice that closed off al avenues to the court's conscience in formulating a decree and disregarded basic principles of equity—was nothing short of an end run around equity.

Noting that Rule 2080 is a "procedural" rule which simply establishes conditions under which FINRA "may" waive its right to appear in a court proceeding seeking expungement, the Court held that a failure to conduct a balancing of the equities when called upon to do so was reversible error. The matter was remanded in order for the trial court to exercise its "inherent equitable powers to weigh the equities favoring expungement against the detriment to the public should expungement be granted."

Analysis and Implications

The *Lickiss* decision confirms that courts are free to exercise their inherent equitable powers, when called upon to do so, in order to determine whether to grant expungement relief. While *Lickiss* does not create a right to expungement relief, it does offer an opportunity to brokers who believe that a case can be made that particular disclosures related to them should be removed under principles of fundamental fairness and equity.

FINRA's reaction to the *Lickiss* decision remains to be seen. A petition to the California Supreme Court would be due in early October should FINRA pursue additional appeals. Also unclear is the impact of *Lickiss* on FINRA's proposed *In Re* expungement process[2] that seeks to provide an efficient process for the potential expungement of claims related to "sales practice violations" in filed arbitrations in which the registered person is not a named respondent. Finally, we expect that NASAA, who along with FINRA, jointly "owns" the CRD system managed by FINRA and has long advocated for a robust and comprehensive disclosure regime, will play an active role in these matters as the reverberations of *Lickiss* are felt in courts throughout the nation. ■

2 See Regulatory Notice 12-18 (April 2012).

For more information about any of the topics covered in this issue of the Securities Law Alert, please contact:

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